

VERMONT STATE TEACHERS' RETIREMENT SYSTEM

Meeting of the Board of Trustees

May 18, 2005

Board Members present:

JOSEPH MACKEY, Chairperson (Active No. 29334), term expiring July 1, 2009

JON HARRIS, Vice-Chairperson (Active No. 25669), term expiring July 1, 2007

JAY KAPLAN, Association of Retired Teachers of Vermont, term expiring July 1, 2008

THOMAS CANDON, representing Commissioner of BISHCA

VAUGHN ALTEMUS, representing Commissioner of Education

JEB SPAULDING, VT State Treasurer

Also attending:

ELIZABETH PEARCE, Deputy Treasurer, Representing JEB SPAULDING, VT State Treasurer

Cynthia Webster, Director of Retirement Operations

David Minot, Director of Investment Services

Bill Rice, Director of Law and Policy

Dick Charlton, Ellen Griggs, Kevin Kondry, New England Pension Consultants

Rita Rinehart, June Atwood, Association of Retired Teachers of Vermont

Patrick Donohoe, and Thomas Poppey, State Street Bank & Trust Co.

The Chairperson, Joe Mackey, called the meeting to order at 8:00 a.m. on Wednesday, May 18, 2005, held in the Suzanna's Restaurant Conference Room at the Hilltop Inn, Airport Road, (Berlin) Montpelier, Vermont.

ITEM 1: Board Action Items

- A. Approval of the Minutes of March 21, 2005 and March 22, 2005

On a motion by Mr. Altemus seconded by Mr. Kaplan, the Board unanimously voted to approve the minutes of March 21, 2005, with the following amendments:

Page 3, UBS Global Asset Management, paragraph 1: ...political debates, UBS *Asset Management Division* does not ...

Page 4, Item 3, paragraph 6: ... he liked them and the people, *historical allocations were not always 50/50*, and wanted to...

On a motion by Mr. Mackey seconded by Mr. Kaplan, the Board unanimously voted to approve the minutes of March 22, 2005, with the following amendment to Item 1: add the complete text of the resolution adopted.

- B. Ratify the Disability Retirement for: Virginia Cameron

On a motion by Mr. Kaplan seconded by Mr. Altemus, the Board unanimously voted to ratify the ballot votes approving the disability retirement for Virginia Cameron, as recommended by the Medical Review Board.

C. Approve Member Appointment

Ms. Webster advised the Board that Mr. Mackey was the only nominee for the four-year, Active Member Representative, seat up for election in 2005.

On a motion by Mr. Harris seconded by Mr. Altemus, the Board unanimously voted to nominate and elect Joe Mackey to a four-year term as Active Teacher Representative.

D. Approve SSgM for International Equity Transition Management

Mr. Minot explained the request before the Board was simply an addition to the language in the previously approved transition management contract.

Mr. Minot also advised the Board of receipt of an approved Bulletin 3.5 waiver from the Secretary of Administration permitting open-ended contracts, and waiver of some RFP regulations.

On a motion by Mr. Candon seconded by Mr. Harris, the Board unanimously voted to add international equity language to the previously approved transition management contract with SSgM.

E. Discuss/Act on Actuary RFP Finalist Presentations

Mr. Mackey made a motion seconded by Mr. Altemus, to retain Mellon Consulting, and direct staff to initiate fee negotiations.

Mr. Kaplan made a motion for amendment to add a proviso that contract services would be prohibited from being outsourced, over seas. *Amendment failed due to lack of a second.*

Mr. Candon made a motion for amendment seconded by Mr. Altemus, to add a proviso that the Contractor must notify the Board immediately of any intention, or action, to outsource any contract services over seas.

The Board unanimously voted to approve the original motion and second amendment.

The Board discussed the need for an audit of the actuary.

On a motion by Mr. Kaplan seconded Mr. Mackey, the Board unanimously voted to initiate a process to enable contracting with a firm to audit of the current actuary, to begin no later than December 1st.

Ms. Pearce will investigate Bulletin 3.5 requirements regarding the appropriate RFP process.

Mr. Spaulding arrived at the meeting, and Ms. Pearce stepped down.

ITEM 2: Investment Consultant Quarterly Report for Q1/05 – NEPC

Mr. Charlton, Ms. Griggs and Mr. Kondry reviewed the first quarter 2005 performance. They reported the market value of the fund balance at approximately \$1.316 billion and a gross quarterly return of (1.3)%, an under performance of the (1.0)% median public fund. The one-year return was 8.4% vs. the median public fund at 6.6%, three-year return 8.0% vs. the median public fund at 6.8% and a five-year return of 4.5% vs. 3.5%.

A. Contract Issues

Mr. Minot provided information to assist the Board in a discussion regarding the status of the large cap index management transition, including issues with proposed Trust Agreement language in the commingled SSgA Index contract allocation. He explained language in the Trust Agreement included indemnities and representations that state - the Board's tax-exempt status, authority to enter into a contract, execution of the contract is authorized, and the contract is legally binding. Mr. Rice discussed the "indemnify and hold harmless" language for SSgA and participating funds, and advised the Board on the State's historical position not to endorse contracts with indemnifications.

On a motion by Mr. Spaulding seconded by Mr. Mackey, the Board unanimously voted to authorize proceeding with execution of the contract with SSgA, understanding the indemnification and representation language, as discussed.

Mr. Minot advised the Board he recently learned the PIMCO investment vehicle, previously approved, included a three-party agreement between the system, PIMCO, and the three brokers who would be purchasing future contracts. He explained the agreement contained rather severe language to indemnify against losses in future contracts, which could jeopardize the corpus of the fund. He also explained features of an alternative option, to enter into a separate limited partnership agreement vs. the investment agreement, advising the AG's Office would still need to examine and concede to the limited partnership representation and indemnification language.

Mr. Minot distributed details and fee schedules for the PIMCO StocksPLUS, Part A & B investment vehicles. The Board acknowledged the LP contained a performance fee structure, which would be a deviation from the retirement system's past practice in contract negotiations.

Mr. Candon made a motion seconded by Mr. Altemus, to authorize investigation by the Treasurer's Office and Attorney General's Office of the PIMCO StocksPLUS Limited Partner, Part B version, and report back to the Board.

Mr. Kaplan made a motion seconded by Mr. Mackey, to amend the motion to add investigation and reporting on mutual fund options, in addition to the StocksPLUS product.

The Board unanimously voted to approve the original motion and amendment.

Mr. Candon left the meeting.

B. Discuss/Approve Investment Policy Guideline Revisions

Ms. Griggs led the Board in a review of the guideline amendments, which included amendments to section B pages 3-5, and 8-11.

On a motion by Mr. Mackey seconded by Mr. Harris, the Board unanimously voted to adopt the Investment Policy Guideline amendments, as submitted by NEPC, with the exception of B3.

Ms. Griggs advised the Board Loomis Sayles contacted her regarding an SDIA holding in the highly rated, Community Program Loan Trust, which matures on 2009. She said currently the holding had only one rating of AAA by the S & P rating agency, which was in violation of the Policy that requires two or three ratings. Ms. Griggs said she recommended support for the request by Loomis to retain the holding.

On a motion by Mr. Altemus seconded by Mr. Harris, the Board unanimously voted to authorize Loomis Sayles to retain the single rated holding.

C. Review/Discussion of Environmental Manager RFI Results

Mr. Spaulding advised there were approximately forty responses received in response to the Environmental Manager RFI. He suggested a subcommittee be developed to review the data collected, and select an undetermined number to invite and participate in an RFP process.

On a motion by Mr. Spaulding seconded by Mr. Altemus, the Board voted to allow the Chair to appoint a subcommittee to review the RFI responses, in conjunction with the VSERS, assuming they pass a similar motion, to select an undetermined number of firms to participate in a formal RFP process, and develop the RFP criteria, with the understanding the Board has not committed to an allocation at this time. Mr. Spaulding, Mr. Altemus, Mr. Mackey, and Mr. Harris voted yes. Mr. Kaplan voted no.

With the Board's permission items on the agenda were taken out of order.

Mr. Candon returned to the meeting during the next item.

ITEM 3: Custodian Bank Contract Questions

- A. Securities Litigation/Class Action Filing
- B. Large Cap Equity Transition
- C. Securities Lending
- D. Impact of New Number of Managers on Cost
- E. Impact of Contracts with Three Systems

Mr. Patrick Donohoe, and Mr. Thomas Poppey, Vice Presidents, appeared before the Board. The Board was provided a detailed presentation on securities lending, and securities litigation.

Upon discussion, Mr. Donohoe agreed to provide a securities lending fee cost analysis under varied scenarios, for the Board's review.

On a motion by Mr. Spaulding seconded by Mr. Kaplan, the Board unanimously voted to transfer from the Quality A fund to the Quality D fund, in the Securities Lending Program with State Street Bank & Trust Company, subject to statutory compliance.

The Board requested Mr. Minot and/or NEPC research elimination of indemnifications on securities lending, and agreed to discuss this matter at the next meeting.

Mr. Donohoe agreed to review the services provided by SSB&T, account structure, and fee schedule, with unitization in consideration. Mr. Donohoe also advised the Board while in Vermont he also visited with other Treasurer's Office personnel regarding reporting requirements, litigation reporting, and service model modifications.

The Board agreed to hold a business meeting on June 15, 2005. The agenda and length of the meeting will be determined based on the Chair's review of agenda items to be addressed.

ITEM 4: Review and Discuss Process for Updating

- A. Asset Allocation
- B. Strategic Investments vs. Market Timing

Ms. Griggs advised the Board asset allocations are typically reviewed with the asset liability study at five-year intervals. Mr. Charlton pointed out, however, that NEPC has presented many opportunities and options, some repeatedly, that the Board has elected not to nest within the asset allocations, and unfortunately some funds may close and no longer be available.

The Board discussed transparency, speed of decisions and action, successful progress with recommended changes, opportunistic investing, their desire and need for education, etc.

NEPC will discuss hosting a seminar to review asset classes, recommendations, and investing opportunities with the Treasurer's Office.

ITEM 5: Role and Cost of Proxy Voting in the World of Indexing

Mr. Minot advised the Board indexing would not preclude proxy voting, however, some commingled trust vehicles such as PIMCO StocksPLUS would have no voting, while others in that environment could have pro-rata voting, if successfully negotiated with the trust custodian.

Mr. Minot advised the Board the first quarter proxy voting reports from ISS were examined revealing that manager compliance with the adopted Proxy Voting Guidelines was less than 100%. Mr. Minot suggested an option to expecting managers to completely adhere to the Policy, would be to engage ISS to vote proxies on behave of the systems, for domestic large cap managers, and potentially add small cap

and international money managers. He said an estimated \$40K cost might be expected in exchange for near total compliance with the Policy.

The Board discussed options including going back to managers who vote without ISS and remind them of the policy, hire ISS to vote for all asset classes, taking into consideration whether the manager uses ISS for proxy voting, or stay with the status quo.

Mr. Kaplan suggested joining the Counsel of Institutional Investors and reap the benefits from the weight of that organization. The Board agreed to discuss this proposal at the next business meeting. Mr. Minot will prepare a formal proposal for the Board to consider at a later date, also.

ITEM 6: Sudan: Initiative Response and Board's Policy

Mr. Spaulding advised the Board that Sen. Matt Dunne visited with the VSERS Board at a meeting in April, to discuss the resolution. He said Mr. Kaplan participated via conference call, and the Board took no formal action but requested Sen. Dunne provide specific manager information available that warranted sanction consideration. He advised to date the bill proposal had not been moved forward.

Mr. Spaulding said he felt active ownership, such as proxy voting and shareholder resolutions could be effective in influencing corporate behavior, and that he would prefer trying to effect positive change rather than just selling stock and walking away from an issue. Mr. Spaulding advised the Board that according to his limited information, one of the companies on the short list of potential offenders was Siemens, which is owned within the VSERS. He said he had reached out to the corporate officers to ask what the company is doing in Sudan, and if appropriate ask how the company, or officers of the company, would or could support genocide. Mr. Spaulding said he would continue in his contact attempts.

The Board briefly discussed its role in social and political debates vs. fiduciary responsibility, and the Board expressed its appreciation to Sen. Dunne for bringing the issue to their attention.

ITEM 7: Discussion of GASB 25 and Possible Actuarial Methodology Changes

The Board received a graph prepared by Ms. Pearce visually demonstrating a more accurate portrayal of the system's under funding status, and copy of an actuary recommendation regarding GASB 25 reporting from David Driscoll in a letter dated March 21, 2005. The letter described the current frozen initial liability (FIL) GASB 25 reporting method vs. alternatives, i.e. entry age normal (EAN), and/or statutory amendments.

On a motion by Mr. Mackey seconded by Mr. Harris, the Board unanimously voted to recommend to the legislature a change in actuarial funding method from the frozen initial liability (FIL) to Entry Age Normal (EAN) reporting method.

ITEM 8: Contracts and RFPs – Process and Updates

A. Re-Engineering Project

Ms. Pearce provided an update of the re-engineering project, which is currently on time and under budget. Also provided were drafts of RFP documents, and Advisory Committee information.

Mr. Kaplan and Mr. Mackey questioned the possibility of outsourcing, and asked the Deputy Treasurer to investigate whether other states currently outsource their IT functions. They further questioned the timing in which the Board could withdraw from financing the IT project, if other more economical options, such as outsourcing became available. Ms. Pearce advised the Board was committed and had already approved the 5-year budget expenditure for the re-engineering project.

B. Investment Consultant RFP

Ms. Pearce distributed the draft RFP, requesting feedback in the scope of services and response questions, by May 31. Mr. Mackey proposed hiring a consultant to assist in the Investment Consultant RFP process. The Board discussed serving on a sub-committee to review responses, and narrow to an undetermined number of finalists for Board interviews.

Ms. Pearce also distributed a copy of a May 16, 2005, SEC report regarding findings and examinations of select pension consultants.

C. Future RFPs and Contracts

Ms. Pearce advised the Board SDIA third-party administration RFP responses were still under review. She explained some costs, such as Retirement Office staff time historically had never been, but should be, expensed to the SDIA plan. She said an inclusive calculation of all plan expenses was being prepared, to compare to the responses. Ms. Pearce noted including all expenses in third-party administration, whether contracted or conducted in-house, would definitely have an impact to the participant's rate of return. She said the Board would be kept advised.

ITEM 9: Executive Staff Reports

A. Director of Retirement Operations

Ms. Webster provided a brief legislative update since the publication of her report. She advised the Board there had been no action on H.238; therefore it was included in a comprehensive bill prepared by the Treasurer's Office. Also distributed was a copy of the NCTR Annual Conference agenda.

On a motion by Mr. Altemus seconded by Mr. Harris, the Board unanimously voted to approve Mr. Mackey and Mr. Kaplan's attendance at the October 6-10 NCTR Conference to be held in New Orleans.

Mr. Altemus advised he might also request permission to attend, at a later date.

B. State Treasurer

Mr. Spaulding advised the Board negotiations toward unitization were continuing with a proposal to include all Board members, creating a seventeen-member Pension Investment Committee (VPIC). He said nine members would be required for a quorum and/or action, and the chair position would rotate among the three Boards. The final proposal may also require a minimum number of representatives from each Board be present as part of the quorum.

C. Director of Finance & Investments

Mr. Minot had nothing to add to his written report.

ITEM 10: Any Other Business to Come Before the Board

None

Next Meeting Dates:

The next business meeting is scheduled for June 15, 2005.

The next quarterly investment meeting is scheduled for August 17, 2005.

Adjournment:

On a motion by Mr. Harris seconded by Mr. Candon, the Board unanimously voted to adjourn at 5:50 p.m.

Respectfully submitted,

Donna Holden, Board Coordinator
for
Cynthia Webster, Secretary to the Board